expenses and revenues for the total entity. Under the Commission's proposal, both integrated lines of business would record expenses and revenues for the same exact service flowing through both lines of business. Expenses and revenues would be "double dipped."

Section 272(e)(4) is a straightforward non-discrimination provision that does not require any new accounting rules.[38] If the interLATA affiliate acquires access services or unbundled network elements from the BOC, Section 272(e)(4) requires the BOC to make such services or facilities available to other carriers at the same rates, terms and conditions. The same accounting treatment should be applied by the BOC regardless of the identity of the entity acquiring such services or facilities. If the BOCs provide interLATA services on an integrated basis with existing services, the imputation requirement in Section 272(e)(3) will be triggered, and the accounting appropriate for such imputation will control.

d. Scope of Commission's Authority

The Notice contains an extensive discussion of the interaction between Sections 271 and 272 of the 1996 Act and Section 2(b) of the 1934 Act, as amended. This issue was fully discussed in BellSouth's Comments in response to the *BOC In-Region NPRM*, and BellSouth will not repeat that discussion here.[39] It is sufficient to note that Sections 271 and 272 do not give the Commission plenary jurisdiction over intrastate, interLATA services. Section 2(b) generally deprives the FCC of jurisdiction over intrastate services, and the 1996 Act did not repeal Section 2(b), despite its removal from earlier draft legislation. Therefore, the Commission does not have jurisdiction to preempt state

[38] Notice, para. 42.
[39] *BOC In-Region NPRM*, BellSouth Comments at 15-17 (August 15, 1996).

accounting requirements. In Louisiana Public Service Commission v. FCC, 476 U.S. 335 (1986), the Court held that it was possible to have separate accounting requirements for interstate and intrastate operations. Nothing in the 1996 Act changes that analysis. To the extent that Sections 271 and 272 confer jurisdiction on the FCC over enumerated aspects of intrastate communications, Section 2(b) serves to limit that jurisdiction to only those powers expressly conferred by those sections.

3. Section 275 - Alarm Monitoring Services

BellSouth expresses no opinion regarding the issues raised in Paragraphs 51-56 of the Notice.

4. Section 276 - Payphone Services

BellSouth concurs with the conclusion in the Notice that at this time the Commission should adopt nonstructural safeguards for BOC provision of payphone service that are identical to the Computer III safeguards, as required by Section 276(b)(1)(C) of the 1996 Act.[40] BellSouth believes that such safeguards are more than adequate to fulfill Congress' purpose of preventing the subsidization of payphone service from exchange service or exchange access service operations. Certainly additional burdensome rules for asset transfers, as proposed in the payphone docket,[41] are not contemplated under the Act and must not be mandated by the Commission. For price cap LECs, or BOCs that operate their payphone operations through separate affiliates, the

[40] Notice, para. 58.

[41] In the Matter of Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, CC Docket No. 96-128, Notice of Proposed Rulemaking, FCC 96-254, released June 6, 1996.

Computer III Rules are unnecessary, and the Commission should consider favorably petitions to forbear from such regulation under Section 10 of the 1996 Act.

BellSouth agrees that Congress intended that BOC payphone operations should be deregulated.[42] Deregulating BOC payphone services, and applying the accounting treatment consistent with that status, will comply with the statutory mandate of Section 276. BellSouth agrees with the Commission that Section 276 contains express language that preempts any state requirements inconsistent with the statute or the Commission's implementing regulations.[43]

III. SAFEGUARDS FOR SEPARATED OPERATIONS

The 1996 Act requires that certain business activities by the BOCs be conducted through a separate affiliate. The Commission has had in place for almost a decade rules governing the accounting treatment for transactions between the ILECs and their nonregulated affiliates. BellSouth agrees with the conclusion reached in the Notice, that:

> except where the 1996 Act imposes specific additional requirements, our current affiliate transaction rules generally satisfy the statute's requirement of safeguards to ensure that these services are not subsidized by subscribers to regulated telephone services. . . . We have previously concluded that these rules provide effective safeguards against subsidization. Incumbent local exchange carriers have implemented internal accounting systems for affiliate transactions to help ensure their compliance with these rules. Redesigning these internal systems would impose substantial costs on the carriers.[44]

As BellSouth noted earlier in these comments, the existing cost allocation and affiliate transaction rules were developed in a rate-of-return environment to provide adequate safeguards against subsidization of nonregulated operations and affiliates by the

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[42] Notice, para. 59.
[43] Notice, para. 61.
[44] Notice, para. 64.

regulated operations of carriers. These rules were completely adequate in that environment, and are more than adequate in a price cap environment. No additional amendments to the existing affiliate transaction rules are needed to "provide more optimal protection against subsidization."[45]

The Notice states that the Commission proposed revisions to the affiliate transaction rules in the 1993 *Affiliate Transaction Notice*. What the Notice does not state is that the proposals in the *Affiliate Transaction Notice* received universal criticism from the carriers that would be subject to the revised rules as being unnecessary and unduly burdensome. Indeed, even AT&T and Sprint expressed their overwhelming opposition to the proposals. These proposals are revived in the present Notice without a mention of the extensive record developed in response to the *Affiliate Transaction Notice*. That record demonstrated the undue burden on the carriers that the revisions would impose, and the utter lack of additional protection against subsidization that the proposals would produce. These proposals have not improved with age. There is absolutely nothing in the 1996 Act or its regulatory history to suggest that Congress was dissatisfied with the operation of the present rules. To the contrary, Congress expressly noted the deregulatory intent of the 1996 Act[46], and required the Commission to eliminate unnecessary regulation to the maximum extent possible consistent with the public interest.[47] It is hard to imagine a set of proposed rules more inconsistent with the purpose of the 1996 Act than those proposed in the *Affiliate Transaction Notice* and now resurrected in this proceeding. The

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[45] Notice, para. 65.
[46] Notice, para. 1.
[47] 1996 Act, Section 10.

Commission should retain its existing affiliate transaction rules until such time as they are subject to forbearance under Section 10 of the 1996 Act, and should not adopt the onerous new rules proposed in the Notice for either existing or new affiliate transactions.[48]

B. Specific Services

1. Section 272 - Manufacturing and InterLATA Services

a. Statutory Language

The existing affiliate transaction rules go beyond the statutory requirement that the separate affiliates conduct all transactions with the BOC with which it is affiliated on an "arms length" basis.[49] The existing rules effectively require affiliates doing business with the BOCs that have not established a prevailing market rate for the products or services provided to the BOC to conduct "fully distributed cost" studies, which are not required of non-affiliates and which would never be required in an "arms length" transaction. Furthermore, BOC affiliates have been subjected to extremely time consuming and costly audits by the FCC staff, which no non-affiliate would tolerate and which would never occur in an "arms length" transaction. Thus, the existing affiliate transaction rules are more than sufficient to meet the "arms length" requirement of the 1996 Act.

Section 272 also imposes new requirements on the separate affiliates that go beyond the existing affiliate transaction rules in other respects. For example, Section 272(b)(5) requires that transactions between the affiliate and the BOC be reduced to writing and be available for public inspection. This requirement will confer an unearned advantage on the competitors of the BOCs and their separate affiliates, and should be

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[48] Notice, para. 66.

[49] 1996 Act, Section 272(b)(5).

eliminated under Section 10 of the 1996 Act as soon as possible. Section 272(b)(2) and (3) impose a degree of separation between the BOC and its separated affiliate that goes well beyond existing requirements. Section 272(c) also contains nondiscrimination safeguards that go beyond the existing affiliate transaction rules and will be more than sufficient to prevent subsidization. In light of these statutory requirements, the Commission's proposal to revive the proposals from the *Affiliate Transaction Notice* are entirely unnecessary.

b. Accounting Requirements of Sections 272(b)(2) and c(2)

The Commission's proposal that BOC separate affiliates maintain their books of account in accordance with generally accepted accounting principles ("GAAP") is a reasonable requirement.[50] GAAP accounting ensures that the books and records of the affiliates are consistent and auditable, and that the books accurately reflect the results of operations in all material respects. Since GAAP is the standard that governs accounting by non-regulated firms, a requirement that all BOC separate affiliates follow GAAP will help ensure that transactions are recorded on an "arm's length" basis.[51] BellSouth already has an internal policy that all subsidiaries follow GAAP accounting. Thus, a requirement to follow GAAP will impose no additional administrative costs for BellSouth affiliates.

The Commission should not impose any additional accounting requirements on BellSouth's nonregulated subsidiaries. These companies participate in competitive markets, and any unnecessary administrative costs imposed by the Commission will

[50] Notice, para. 68.
[51] Notice, para. 69.

adversely affect the ability of these firms to compete with firms not required to incur such costs.

c. "Arm's Length" Requirement of Section 272(b)(5)

As stated in the Notice, the existing cost allocation and affiliate transaction rules were designed to emulate "arm's length" transactions.[52] No additional rules are required to meet the "arm's length" requirement of Section 272(b)(5). The changes proposed in the *Affiliate Transaction Notice* are not required to emulate arm's length transactions.[53] To the contrary, the elimination of "prevailing company price" as a valuation method would move the Commission's rules away from "arm's length" valuation methods, and hence away from the requirements of the 1996 Act.

The requirement of Section 272(b)(5) of the 1996 Act that transactions between the BOCs and the separate affiliates required by the Act be "reduced to writing and available for public inspection"[54] can be satisfied by giving these words their plain meaning. BellSouth recommends that each BOC maintain a repository of such contracts at its principal place of business, and that such contracts be made available for inspection upon request. If such contracts contain confidential commercial information, a person requesting access to the contracts should be required to sign an appropriate non-disclosure and confidentiality agreement. Such contracts should not be placed on the Internet. Allowing Internet access to such documents would prevent BOCs from requiring appropriate protection for confidential commercial information that would thwart, rather

[52] Notice, paras. 70-73.
[53] Notice, para. 73.
[54] Notice, para. 74.

than promote, legitimate competition. Nothing in the Act requires that such contracts be filed with the Commission, and no such requirement should be imposed.

BellSouth is puzzled by the discussion in Paragraph 75 of the Notice. If the Commission's intent is to define a request by the separate affiliate for tariffed exchange service and exchange access service as a "transaction" that must be reduced to writing and made publicly available, BellSouth strongly disagrees. BellSouth separate affiliates should be able to order tariffed exchange services and exchange access services using the same ordering mechanisms as any other person. Ordering service from a telecommunications carrier is not a "transaction" per se. It is the provision of the telecommunications service by the carrier, and the payment therefore by the separate affiliate, that constitutes a "transaction". When such services are ordered pursuant to tariff, the tariff itself constitutes the written, publicly available document that defines the scope, terms and conditions of the transaction. If the Commission intends to interpret Section 272(b)(5) as requiring that the separate affiliate's "customer proprietary network information" be made available to third parties, BellSouth respectfully submits that is not a reasonable interpretation of the statute, and would do nothing to promote the statute's pro-competitive purpose.

i. Identical Valuation Methods for Assets and Services

Under the guise of "prescribing uniform valuation methods for all affiliate transactions,"[55] the Commission proposes to require carriers to estimate the "fair market value" of services provided between affiliates, and to apply the asymmetrical asset transfer

[55] Notice, para. 77.

rules to the provision of services. As discussed above, when that proposal was originally advanced in the 1993 *Affiliate Transaction Notice*, the parties that would be subject to these requirements demonstrated through empirical analyses that the requirement would be unduly burdensome and would not materially increase customer protection against subsidization. BellSouth provided a study by Theodore Barry & Associates that showed that the application of the proposed rule to only three of its affiliates that provide services to BST would result in annual increased administrative costs of over $14.4 million.[56] Other LECs reported similar cost estimates. The Theodore Barry & Associates study also concluded that the effective fair market value studies that could be produced would be of questionable usefulness, and that the costs of compliance would greatly exceed any potential benefits. Even those parties that favored the Commission's proposal recognized its burdensome nature.

Such burdensome requirements should be considered only if absolutely necessary to prevent significant abuse of customers to regulated services. However, the *Affiliate Transaction Notice* did not cite a single example of actual carrier conduct that would warrant such draconian remedies. To the contrary, the only justification offered for the Commission's proposal was speculation about how a carrier might abuse the existing affiliate transaction rules. ICA, a party generally endorsing the rules proposed in the *Affiliate Transaction Notice*, called the Commission's attention to the dearth of evidence

[56] Appendix A contains a copy of the original Theodore Barry & Associates study that was filed in response to the *Affiliate Transaction Notice*.

in the record of such conduct.[57] ICA went so far as to remind the Commission that in the absence of specific evidence:

> a reviewing court might not understand the factual bases that more fully support the Commission's proposals. These facts should be elaborated in more detail of the Commission adopts any part of these proposals.[58]

Despite ICA's coaching, the Commission never put a factual basis for its conclusions on the record in the *Affiliate Transaction Notice* proceeding. The record closed with no party providing the Commission with a single example of actual abuse.

In the Notice, the Commission again speculates that abuse of the existing rules is possible. Again, however, not a single example of actual abuse is given. Presumably, if the Commission staff had evidence that such an abuse had occurred, it would be documented in the Notice.

The absence of any evidence of actual abuse of the existing rules is hardly surprising. For the Commission to create the specter of abuse, it must make the unwarranted assumption that the increased costs resulting from such abuse would be reflected in the rates for regulated services.[59] Under price cap regulation, however, a carrier could have no expectation that it would be allowed to raise rates for regulated services to recover the cost increases incurred through manipulation of affiliate transactions. Since the Commission's "abuse" theory was first articulated (but not documented) in 1993, the largest LECs have been operating under price cap regulation for another three years. Rates for telecommunications services have migrated further away

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[57] *Affiliate Transaction Notice*, Comments of ICA at 5.
[58] Id., Comments of ICA at 6.
[59] Notice, para. 77 states: "If these increased costs are reflected in rates for regulated telecommunications services, ratepayers may be harmed."

from accounting costs towards efficient levels during that time. In the absence of a means to raise regulated rates to reflect these contrived costs, the foundation for the Commission's "abuse" theory crumbles. The proposed rules have no foundation in fact, would be extremely burdensome, and would produce no additional customer protection. Under these circumstances, the proposed rules are in direct conflict with Congress' deregulatory intent in adopting the 1996 Act.

The Commission's attempt to breathe new life into this discredited proposal by linking it to the requirement of Section 272(b)(5) that transactions with the new separate affiliates be conducted "on an arm's length basis" is disingenuous.[60] As noted above, the existing affiliate transaction rules were adopted to emulate the results of "arm's length transactions", and no evidence has been provided that these rules have been inadequate in practice to protect consumer interests.[61] There is simply no public interest basis to adopt burdensome new affiliate transaction rules at this time. To the contrary, the Commission should eliminate even the existing cost allocation and affiliate transaction rules pursuant to Section 10 of the 1996 Act as soon as possible.

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[60] Notice, para. 78.

[61] The Notice, para. 78, cites the NYNEX Order to Show Cause, 5 FCC Rcd 866 (1990), for the proposition that the treatment of services under the current affiliate transaction rules "may reward a carrier's imprudent acts of buying services for more than, and selling services for less than, fair market value." The NYNEX Show Cause Proceeding was settled without an adjudication of any wrongdoing on the part of that carrier. The conduct alleged by the Commission occurred prior to the adoption of the current affiliate transaction rules, and while NYNEX was subject to rate of return regulation. For the Commission to cite the NYNEX Show Cause proceeding as the sole evidence of the need to adopt new rules a decade after the challenged conduct occurred, and after six years of price cap regulation, demonstrates just how far the Commission must reach to attempt to justify the proposed rule.

BellSouth believes that the existing affiliate transaction and cost allocation rules are more than sufficient to meet the requirements of Section 272(e)(4). The requirement that such facilities and services are made available to all carriers at the same rates and on the same terms and conditions ensures that such transactions will occur on an "arm's length basis". No new requirements are needed to ensure that "the costs are appropriately allocated."[62]

ii. Prevailing Company Prices

The Notice contains the bizarre proposal to read Section 272's requirement of "arm's length transactions" as justification for eliminating "prevailing company price" as a valuation method in transactions between BOCs and their Section 272 affiliates. The Notice defines the "prevailing company price" as "the price at which a company offers an asset or service to the general public."[63] Despite express recognition that such a price represents "the price that would be paid in an arm's length transaction,"[64] the Commission proceeds to raise a concern that the costs associated with providing such services to affiliates and non-affiliates may vary.[65] For an agency that has been administering price

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[62] Notice, para. 79.
[63] Notice, para. 80.
[64] Id.
[65] In response to the *Affiliate Transaction Notice*, Sprint provided unchallenged evidence that refuted the Commission's premise that sales to the carriers by their affiliates do not require that the incur the marketing costs that are incurred to achieve sales to non-affiliates. Sprint filed the Affidavit of Steve L. McMahon, Executive Vice President - Operations of North Supply Company, a wholly owned subsidiary of Sprint Corporation and an affiliate of the United and Central Telephone Companies. Mr. McMahon provided sworn testimony that directly contradicted the Commission's assumption that "sales between affiliates usually do not require extensive marketing efforts and generally involve lower transactional costs than sales to non affiliates." Mr. McMahon testified that "The costs of transaction processing and marketing to affiliates does not materially differ from that involved in non-affiliate marketing." *Affiliate Transaction Notice*, Comments of

cap regulation for the large LECs for six years, the appropriate response to this observation is obviously, "So what?" Rather than acknowledge the obvious response, however, the Commission proposes to eliminate prevailing company price as a valuation method for transactions between the BOCs and their Section 271 affiliates. The Commission's continued fixation on costs is totally inconsistent with price cap regulation and with the emergence of competition that the 1996 Act was designed to foster.

The Commission seeks to justify the elimination of the "prevailing company price" valuation method because of the alleged difficulty of defining what constitutes a prevailing price.[66] To the extent that there is any problem in this area, it is a problem of the Commission's own making. The Commission's audit staff adamantly refuses to apply plain English, common sense meaning to the concept of a prevailing company price. For example, in the Notice, the Commission poses the question, "what percentage of an affiliate's overall business must be provided to non-affiliates in order to establish a prevailing company price?"[67] The simple answer is that if a reasonable number of third party purchasers are willing to buy from the affiliate at the stated price, that price may be presumed to be reasonable. The Commission does not need to establish a fixed percentage of sales to evaluate the likelihood that the price is excessive. For large, expensive items, a few third party sales may be sufficient to give assurance of reasonableness. For smaller items, more sales may be required. Trying to impose a "bright line" percentage of sales that will give assurance of reasonableness is to elevate

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Sprint, Attachment 1, para. 6. Mr. McMahon's Affidavit is not even acknowledged, much less refuted, in the Notice.

[66] Notice, para. 81.

[67] Id.

form over substance. Unfortunately, it is precisely such myopic enforcement of the rules that leads to the "difficulty" the Commission staff has experienced under the current rules. The Commission can avoid the "difficulty" associated with the "prevailing company price" valuation method by providing its staff with guidelines that focus enforcement efforts on transactions that may have a significant impact on the prices charged by the LEC to its regulated service customers. If the transactions in question do not have that potential, there is no need to conduct an audit.

Eliminating "prevailing company price" would not be benign tinkering with the affiliate transaction rules. In addition to eliminating the valuation method that best meets the statutory requirement to ascertain whether transactions are "arm's length", the elimination of "prevailing company price" would require the BOCs and their affiliates to incur additional costs to perform estimated fair market value and fully distributed costs studies in situations where those studies do nothing to provide additional customer protection. BellSouth discusses the combined impact of eliminating "prevailing market price" as a valuation method and adopting "identical valuation methods" for transfers of assets and the provision of services in the next section of these comments. There BellSouth shows that these changes in the rules would impose very significant new administrative costs and burdens on the BOCs with virtually no additional protection for customers. As such, the adoption of these proposals is directly contrary to the deregulatory intent of the 1996 Act.

iii. Estimates of Fair Market Value

The Commission's proposal to adopt "identical valuation methodologies for assets and services"[68] is a holdover from the 1993 *Affiliate Transaction Notice*. In that docket, BellSouth described the extremely burdensome nature of such a requirement. In summary, BellSouth noted that while there are generally accepted methodologies to appraise assets, there are no universally accepted methodologies to evaluate services. Some services, like transaction-based services such as accounts receivable, lend themselves to a ready determination of fair market value because there is an established market for companies wishing to outsource such requirements. Other services, such as strategic planning, require unique knowledge of the firm, and therefore defy market-based valuation. BellSouth retained Theodore Barry & Associates to estimate the additional cost, as well as the effectiveness, of the Commission's proposal in the *Affiliate Transaction Notice* to apply the asset transfer methodology to services. Looking at only three of BellSouth's affiliates, BellSouth Corporation, BellSouth Business Systems and Bellcore, Theodore Barry & Associates estimated the annual recurring cost of performing the required studies to estimate of fair market value at $14.4 million. This estimate did not include the services provided to BST from other affiliates. Nor, of course, does it include the costs of applying these rules to the new affiliates required by the 1996 Act.

Theodore Barry & Associates also concluded that applying estimated fair market valuation techniques to service transactions would be of questionable usefulness to the Commission or to ratepayers. For the growing number of "knowledge-based" services,

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[68] Notice, para. 83.

involving planning and strategy development, there are no ready market comparisons, rendering the results of estimated fair market value studies inconsistent and of questionably validity. The primary effect of adopting such a requirement would be to curtail otherwise mutually beneficial affiliate transactions, which would put BellSouth and its affiliates at a competitive disadvantage. Theodore Barry & Associates concluded that the burden associated with the proposed rules would outweigh any benefit associated with more effective monitoring of affiliate transactions.

In the Notice, the Commission recognizes the difficulty of estimating the fair market value of service transactions. The Commission's answer is to refrain from prescribing specific methodologies for such studies, and instead require carriers to make "good faith determinations" of fair market value.[69] This does not solve the problem associated with the Commission's proposal for two reasons. First, the cost estimates by Theodore Barry & Associates already assume that BellSouth could use the most cost effective method to perform the required studies. Thus, the $14.4 million price tag would not be reduced by the "good faith" requirement of the proposed rules. Second, the carrier's "good faith" attempts to comply with the rules are going to be evaluated with 20/20 hindsight in either audit or formal complaint proceedings. In either context, BellSouth and the other carriers subject to these rules will never know for certain whether its efforts will be deemed sufficient to meet the "good faith" requirement of the Rules. Thus, not only will the carriers subject to these rules incur substantial costs and potentially forego valuable affiliate transactions, but they will also be under a perpetual cloud of

[69] Notice, para. 83.

possible enforcement proceedings. This will put a substantial chilling effect on desirable and cost-effective affiliate transactions.

For example, BST currently receives cellular service from an affiliate, BellSouth Cellular. BellSouth Cellular sets its prices in a competitive market, and offers BST service at a prevailing company price. If the Commission adopts its proposal to eliminate prevailing company price as a valuation methodology, and to apply the asset transfer rules to services, BellSouth Cellular would have to incur the cost to perform fully distributed cost studies and estimated fair market value studies in order to sell cellular service to BST. These are costs that BellSouth Cellular has no reason to incur for its internal operations, and which add no value to its firm. BellSouth Cellular might well decide that it is not worth it to incur such costs simply to have an opportunity to compete for BST's business. Even if BellSouth Cellular is the low price provider in a given market, BST would be forced to acquire cellular service from a higher priced competitor purely as a result of the proposed affiliate transaction rules. Both BellSouth Cellular and BST would be damaged, and no benefit would accrue to BST customers.

This concern applies with even greater force to new separated affiliates required under the 1996 Act. These new affiliates will be entering highly competitive markets from scratch. The imposition of unnecessary regulatory burdens on these entities will have a strong chilling effect on their willingness to engage in otherwise desirable transactions with BST. The Commission should not distort the market in the absence of a compelling reason to do so, and no such compelling reason exists. The Commission should withdraw the proposed modifications to the affiliate transaction rules. They are onerous and ill-conceived, and should not be adopted.

iv. Tariffed-based Valuation

The Notice seeks comment on the status of tariffed-based valuation if ILECs are not required to provide interconnection and collocation services and network elements pursuant to tariffs.[70] BellSouth agrees that the affiliate transaction rules should be amended to treat statements of generally available terms and conditions adopted pursuant to Section 252(f) of the 1996 Act, and interconnection contracts adopted by negotiation or arbitration as acceptable valuation methods. The rates, terms and conditions of such agreements must be made generally available, thereby precluding any abuse of affiliated relationships. Affiliates should be neither favored nor handicapped in connection with interconnection, collocation or access to unbundled network elements. Such a result is required by Sections 272(e)(3) and 272(e)(4) of the 1996 Act, which supersede any inconsistent positions in the Commission's affiliate transaction rules. The Commission should conform its rules to the requirements of the 1996 Act.

v. Return Component for Allowable Costs

As described in the Notice, the Commission currently requires affiliates using fully distributed cost as a valuation methodology to include a return component at the currently prescribed LEC interstate rate of return.[71] The Commission seeks comment on whether this requirement should be extended to the separate affiliates required by Section 272 of the 1996 Act.[72]

The existing rules have theoretical infirmities. There is no reasonable basis to assume that the cost of capital of a nonregulated affiliate is the same as the cost of capital

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[70] Notice, para. 86.
[71] Notice, para. 87.
[72] Notice, para. 88.

of the regulated LECs. Nevertheless, the practical difficulties of determining the cost of capital of each nonregulated affiliate of a BOC mentioned in the Notice have led the Commission and the industry to accept the prescribed LEC rate of return as a surrogate for the affiliate's cost of capital.

BellSouth has no objection to extending the current practice to the new affiliates created to comply with Section 272, provided the Commission does not eliminate prevailing company price as a valuation method. These new subsidiaries will be competing in highly competitive markets, and their cost of capital will be determined by the risks associated with those markets. BellSouth anticipates that these new affiliates will clearly establish a prevailing company price that is based on the risk and competitive conditions in each market. There is no reason for the Commission to distort those competitive conditions by eliminating prevailing company price as a valuation method and substituting fully distributed cost for transactions with the BOCs.

d. Application to InterLATA Telecommunications Affiliates

The Notice proposes to apply the affiliate transaction rules to transactions between a BOC and any affiliates it establishes under Section 272(a).[73] The Commission recognizes that transactions between the BOC and its interLATA telecommunications services affiliate are between regulated entities, and that the existing affiliate transaction rules are solely designed for transactions between regulated carriers and their nonregulated affiliates. The Commission nevertheless proposes to apply the affiliate transaction rules to transactions between the BOCs and their interLATA affiliates.

[73] Notice, para. 89.

There is no logical basis for the Commission to extend the affiliate transaction rules to "regulated-to-regulated" transactions. Both the BOC and the new interLATA affiliate are subject to Title II of the Communications Act, and each has a statutory obligation to establish just, reasonable and non-discriminatory rates. As BellSouth has shown above, the existing affiliate transaction and cost allocation rules have outlived their usefulness for carriers that have been subject to price cap regulation for six years and counting. Any attempt by a BOC to subsidize its interLATA affiliate would fail because the BOC cannot raise prices to recover the costs incurred in the subsidization attempt. The new interLATA affiliate will be competing with entrenched giants such as AT&T, MCI and Sprint. Its prices will be dictated by the marketplace, not by its costs. Thus, the application of the affiliate transaction rules in this context will increase the administrative costs of both carriers with no corresponding benefit to the public. Under such circumstances, Section 10 of the 1996 Act prohibits the adoption of such regulations.

Another reason not to apply the affiliate transaction rules to transactions between the BOC and its Section 272 interLATA affiliate is that the separate subsidiary requirement is an interim measure designed to sunset after three years.[74] Thus, the costs incurred to create internal accounting and tracking systems to comply with the affiliate transaction rules would be wasted after a brief period of time. Requiring a new entrant to incur substantial regulatory costs not imposed on the incumbents is anti-competitive and contrary to the letter and spirit of the 1996 Act.

[74] 1996 Act, Section 272(f)(1). The separate subsidiary requirement for interLATA information services is designed to sunset after four years under Section 272(f)(2).

The suggestion in the Notice that the Commission might impose cost allocation rules to separate the regulated and non-regulated activities of the separate interLATA affiliate is outrageous.[75] Both the regulated interLATA operations of the new affiliate and its nonregulated operations will be conducted in fully competitive markets that the new affiliate will enter with zero market share. There is absolutely no incentive or ability for such an entity to manipulate costs between lines of business, since such cost shifting would have absolutely no impact on the prices charged for the services provided by that entity. As Dr. Darby's testimony quoted at the beginning of these comments noted, in competitive markets, joint and common costs are absorbed by various lines of business through operation of the marketplace without any arbitrary allocation of such costs by the entity or by external forces. There is simply no reason for the Commission to impose arbitrary cost allocation rules on an entity that will be operating solely in competitive markets. Arbitrary cost allocation rules are not imposed by the Commission on existing participants in the interLATA marketplace, despite the fact that these carriers are subject to Title II regulation, and all offer other, non-regulated lines of business. It would be arbitrary and capricious and an abuse of discretion to single out the interLATA affiliates of the BOCs for such treatment.

e. Application to Joint Marketing

The Notice proposes that the cost allocation and affiliate transaction rules be extended to apply to any joint marketing of interLATA and local exchange services permitted by Section 272(g) of the 1996 Act.[76] For the reasons discussed in the prior

[75] Notice, para. 90.
[76] Notice, para. 91.

section of these comments, such a requirement is unnecessary to protect customers of either existing BOC services or the customers of the new interLATA affiliate. Under price cap regulation, the BOC has no incentive to shift costs among its lines of business, since such cost shifting will not change the price charged for its products and services. The Commission should eliminate, not extend the reach of, its cost allocation and affiliate transaction rules.

f. Audit Requirements

Section 272(d) of the 1996 Act requires a biannual audit of compliance with the requirements of Section 272. The Notice proposes rules to establish the scope of such audits.[77] BellSouth agrees with the first three criteria set forth in the Notice. BellSouth does not agree that item 4 is necessary, since it is already covered in item 2.

BellSouth recommends that the Commission change the Joint Cost Audit to a biannual audit, and that the Joint Cost Audit and the new audit required by Section 272(d) be conducted in alternate years. This would reduce the cost and burden of major audits to one per year, which would be of benefit to the carriers, their customers and the Commission.

g. Scope of Commission's Authority

The Notice tentatively concludes that the same analysis that applies to telemessaging should be applied to other interLATA information services.[78] While telemessaging meets the statutory definition of an information service, the 1996 Act contains separate sections dealing with telemessaging and interLATA information

[77] Notice, paras. 92-93.
[78] Notice, para. 94.

services. BellSouth believes that the separate subsidiary requirement applicable to interLATA information services in Section 272(a)(2)(C) of the 1996 Act facially violate BellSouth's rights under the United States Constitution. This requirement abridges BellSouth's First Amendment right of freedom of speech, and constitutes a prohibited Bill of Attainder in violation of Article I, Section 9, clause 3 of the Constitution. BellSouth has previously discussed the jurisdictional and constitutional implications of any action by the Commission to impose a structural separation requirement on the provision of interLATA telemessaging services by the BOCs, and adopts by reference its comments in response to Paragraph 94 of the Notice.

2. Section 273 - Manufacturing by Certifying Entities

BellSouth concurs with the Comments filed by Bell Communications Research (Bellcore) dealing with the Section 273 requirements for manufacturing by a certifying entity.[79]

3. Section 274 - Electronic Publishing

BellSouth believes that the electronic publishing restrictions on the BOCs in Section 274 of the 1996 Act facially violate BellSouth's rights under the United States Constitution. These provisions abridge BellSouth's First Amendment right to freedom of speech, and constitute a prohibited Bill of Attainder in violation of Article I, Section 9, clause 3 of the Constitution.

BellSouth recognizes, of course, that this Commission has no power to declare unconstitutional any provision contained in an Act of Congress. Since BellSouth believes

[79] Notice, paras. 95-100.

that Section 274 is facially unconstitutional, this Commission may not adopt a construction of this section that can save it.[80]

In the event that Section 274 of the 1996 Act is not held to be facially unconstitutional, BellSouth offers the following comments on implementation of this section.

a. Comparison of Sections 274 and 272

The Notice seeks comment on whether the use of the term "separated affiliate" in Section 274 requires different accounting treatment than that applied to a "separate affiliate" in Section 272.[81] Nothing in the legislative history of the 1996 Act suggests that Congress intended any different accounting requirements between an BOC and its Section 272 affiliates and its Section 274 electronic publishing affiliate or joint venture.[82] The existing affiliate transaction rules are more than sufficient to satisfy Congressional concerns about asset transfers between the BOC and the separated affiliate.[83] The remaining requirements of Section 274 are spelled out in detail in the statute, and require no additional implementing rules by the Commission.

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[80] Compare BellSouth's comments on the telemessaging provisions of the 1996 Act, above, wherein BellSouth recommends interpretations by the Commission that could serve to preserve the constitutionally of the Act as applied.

[81] Notice, para. 105.

[82] The use of different terms in these two sections is related to the required degree of separation from the BOC. Section 272(a)(1)(A) simply requires a subsidiary separate from the operating company. Thus, a Section 272 "separate affiliate" could be a subsidiary of the Bell operating company. Under Section 274(I)(9), a "separated affiliate" may not be "owned or controlled by a Bell operating company".

[83] 1996 Act, Section 274(b)(4).

b. Audit Requirements

As discussed above in connection with the audit requirements under Section 272, BellSouth believes that the fourth audit requirement proposed in the Notice is duplicative of the second requirement, and is, therefore, unnecessary.[84]

With regard to proprietary information contained in the compliance review report,[85] BellSouth believes that the most appropriate way to protect such information is to have the reviewing entity supply the report to the BOC, which would then file the report with the Commission. If the report contains proprietary information, the BOC would file a public version, with the proprietary information redacted, and a confidential version that would not be routinely available for public inspection. The BOC could request proprietary treatment under the Commission's existing rules.[86] Any party seeking access to the confidential version of the compliance review report should be required to make a persuasive showing that access is necessary to enforce or pursue remedies under Section 274. If the Commission finds that a persuasive showing has been made, it could order release of the confidential information pursuant to a protective order reasonably limiting access to and use of the report. The Commission's existing procedures for handling trade secrets and confidential commercial information would be employed.

c. Section 274(f)'s Reporting Requirement

Section 274(f) requires any Section 274 separated affiliate to file with the Commission an annual report in a form substantially equivalent to SEC Form 10-K. The Notice proposes that if separated affiliates file a Form 10-K with the SEC, they also file

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[84] Notice, para. 106.
[85] Notice, para. 107.
[86] 47 C.F.R. §0.457(g) and 0.459.